

ER 61 - 5737/a

STAT

23 July 1961

cauf
Mr. Dan H. Fenn, Jr., Editor
Harvard Business School Association
Alumni Center, Soldiers Field
Boston 63, Massachusetts

Dear Mr. Fenn:

Referring to your letter of July 15 with regard to my address at the Thirty-First Annual National Business Conference, Harvard Business School, 9 June 1961, I enclose herewith a mimeograph copy of the manuscript which I prepared for that address.

I had a number of requests for copies of the speech and it is this manuscript that I distributed to quite a few people. It differs only in minor respects from the text as actually delivered, particularly in the opening paragraphs where I took some liberties with the text before me. Also in speaking, I did a little "adlibbing" here and there and one or two paragraphs in the text were omitted because of the time element.

To avoid having two texts in public circulation, I should prefer that you use the enclosed text.

I want you and your colleagues to know how much I enjoyed my visit to the Harvard Business School.

Sincerely,

SIGNED

Allen W. Dulles
Director

Enclosure

AWD/jh

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ER 61-5737/a

Mr. Dan H. Fenn, Jr., Editor
Harvard Business School Association
Alumni Center, Soldiers Field
Boston 63, Massachusetts

Dear Mr. Fenn:

Instead of editing the manuscript forwarded by you to me in your letter of 14 July 1961, I am attaching hereto two copies of my address at the Thirty-First Annual National Business Conference, Harvard Business School, 9 June 1961, which you may publish in the August issue of the HBS Bulletin and for the McGraw-Hill book based on the conference.

I note your manuscript omits the first two paragraphs of my address. I believe they should be included. They are pertinent to the overall subject of "Incentives in the Soviet Union". I, therefore, request that you use in its entirety, the attached manuscript rather than the manuscript you submitted for my editing.

I want you and your colleagues to know how much I enjoyed my visit to the Harvard Business School.

Sincerely,

Allen W. Dulles
Director

Enc.

DDCI/SJGROGAN/clb (19 July 1961)

Distribution: Orig - Add

- 1 - DCI via reading
- 1 - DDCI
- ✓ 1 - ER
- 1 - SJG

MEMORANDUM FOR: THE RECORD

Pursuant to the Director's instructions, I advised Mr. Dan H. Fenn on 2 August 1961 that there was no objection to his using the manuscript enclosed with his letter of 14 July 1961 for publication in the August issue of the HBS Bulletin and for the McGraw-Hill book based on the conference.

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JSE/mg

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FORM NO. 101 REPLACES FORM 10-101
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HARVARD BUSINESS SCHOOL ASSOCIATION

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July 14, 1961

Mr. Allen W. Dulles, Director
Central Intelligence Agency
Washington, D.C.

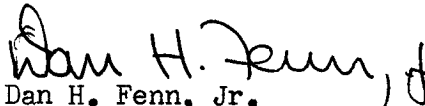
Dear Mr. Dulles:

May we have your approval of the enclosed manuscript of your address, "Incentives in the Soviet Union" (presented at the 31st Annual National Business Conference, Harvard Business School, June 9, 1961), as prepared for publication in the August issue of the HBS Bulletin and for the McGraw-Hill book based on the conference?

I would appreciate it if you could correct any errors which may have crept into the article in the course of our editing and return the corrected copy to us as soon as possible.

Thank you.

Very truly yours,


Dan H. Fenn, Jr.
Editor
HBS Bulletin

DHF/nbc
encl: 2 ms.

JUL 18 REC'D

Incentive, the dictionaries tell us, is that which incites to determination and action, that which moves the mind or stirs the passions. As we have all seen, the forces which motivate men are imparted from without or engendered from within the individual.

Thus, external situations provide incentive. A great crisis stirs men to action; a war inspires us to deeds of courage and exhibitions of fortitude. Similarly, leaders of men, in free societies, in government or in private life can gain influence over men's minds and become the driving force that leads them to action. Dictators, too, can do this on a massive scale.

And then there are the incentives which come from within us -- ambition, religious fervor, the urge to reach for fame or fortune, to create, or to build. It may be an edifice, a work of art, a piece of literature, an invention, a business enterprise, a career.

One of the principal factors distinguishing a free from a totalitarian state is the relative importance given to internal as opposed to external incentives. In an open society, in a government of the people, and for the people, it is from the individual that the major incentives spring. In a closed society, the individual is forced to look primarily to the dictator, to the leader, or to the State.

Not many years ago we saw the strange and sad phenomenon of a great country and a great people seized by a mad dictator, Hitler, who took hold of the minds of the population and molded a controlling group into blind obedience to the State. Individual incentive was lost in the image of the Reich, and Mein Kampf was the bible.

In the Soviet Union the major incentives, too, are derived from the dictates of the State. It is true that, as contrasted with the old Stalin days, there has been some relaxation under Khrushchev. The framework is more ample. But the State still serves as the primary source and control of incentives.

An eminent student of Soviet affairs, Philip E. Mosely, writing in the April 1961 issue of Foreign Affairs, puts it this way:

"The picture of a Soviet system that has chosen, or been driven --- to abandon its police controls and to leave the way open to all kinds of initiatives welling up from below is a most appealing one, but one that can hardly stand the light of Soviet day."

However, we should not lose sight of the fact that even in a system which is basically authoritarian, there is a place for individual incentive and initiative. We tend to view the world in totally black and white terms; in fact, all societies tend to be mixtures, with an all-important difference in emphasis and in goals to set them apart one from the other.

So the Soviets are showing some degree of pragmatism and flexibility and have recognized the need for individual incentive in their system. Take the case of Lysenko, the notorious geneticist, whose theories have long been ridiculed by Western scientists and even by some of his Soviet colleagues. Khrushchev had this to say of him:

"Lysenko is a narrow, authoritarian, sectarian individual who wishes to impose his scientific doctrine on everybody by sending all those who don't agree with him to Siberia. He's an impossible person. However, I prefer a bad character who can grow wheat to a good character who can't."

It is true, of course, that while the scientist may be free to expound the laws of science, he is not free in charting the course of his conduct. There must be a conformity with the needs of the State. But within these very important limits, Khrushchev has recognized that politics can not dictate the findings of the scientist.

Similarly, in order to mold the Soviet people and to supply them with incentives which will contribute to the growth of the Soviet Union, there are

a series of incentive-creating principles which the Soviet leaders, and Khrushchev in particular, teach.

The first, and possibly the most important, is the doctrine they preach the supremacy of the Communist way of life. Communism they portray as the wave of the future. "We will bury you," Khrushchev says to the rest of us, "not physically, but by evidencing the superiority of our system, and the decadence of yours." He proclaims that just as capitalism took over from feudalism, so communism will take over from capitalism.

Second, Khrushchev declares that Communist society has found the keys to industrial and scientific progress; that it is moving ahead at a faster rate than its great industrial rival, the United States; and that in the course of a decade or so it will surpass us in the actual value of its industrial production. Meanwhile, the Soviets claim leadership in space, in ballistic missiles, and in certain other fields of industrial endeavor.

And finally, to maintain communist growth, Khrushchev enjoins each and every Soviet citizen to play his part in the manner and form dictated by the State. He must devote to the State the products of his mind; the fruits of his toil. He must help to overfulfill the goals of the economic plan.

When Khrushchev visited Los Angeles in September 1959, he engaged in a brisk debate with one of his hosts at a luncheon. The issue ^{was} argued over who had come from the humblest beginnings to the highest place in life and society. In the course of it, Khrushchev called on the chairman of the Dnepropetrovsk Economic Council to rise and take a bow. He pointed out that this official administered huge metallurgical plants and chemical factories. A third of the ore mined in the Soviet Union comes from his region; no one in the United States controlled so much wealth, he said. Khrushchev went on to say that the chairman himself possessed nothing except the pants he wore. All the rest belongs to the people, he told his audience.

The fact is, however, that Soviet officials possess great power, as well as pants, and power is a tremendous incentive to the ambitious Soviet citizen. While this is true in America as well, the Soviet manager has much more responsibility for his workers than does his American counterpart. He controls schools, housing, rest homes, and part of the food supply for all the workers in his plant. He has, justifiably, a strong sense of paternal power and achieving this position is a real incentive for him. Furthermore, there are other incentives built into the Communist ^{system} ~~scheme of things~~.

The Soviets were the first to develop the idea of the five-year plan, with an indication of how much should be produced each year. This scheme makes each industrial worker a kind of participant in a race to see that each year's goals and the total is over-fulfilled. In effect, every Soviet worker is taught to feel that he is an integral part of this great industrial marathon between the U.S. and the Soviet Union. Travelers to the Soviet Union report that the slogan "Beat America" is inscribed on cowbarns in various parts of the USSR.

By contrast, ~~in~~ a free society does not attempt to gear its industrial production to that of any other country. Rather, it responds to the demands of the market place; it is provided with both its dynamics and its leadership by what the people may want to acquire to advance their standards of living.

What I have been describing is an over-all popular incentive to help realize national goals. In addition, there are managerial incentives which are applicable to industry, and the nature of these incentives has been a matter of unprecedented concern in the USSR over the past two years.

It is quite clear that Soviet political leadership has succeeded in devising incentives which bring capable managers to positions of key responsibility. But, in the Soviet Union, the politicians do not trust the business managers. To help rule them they have established elaborate controls and checks, under the supervision of local Communist Party types, on the heads of enterprises.

These include the setting of detailed production targets, the allocation of raw and semi-processed materials, the control over manpower, the allocation of investment funds, the control over prices, and the monitoring of performance.

The Party also sees to it that the managerial class is very well paid by Soviet standards. Indeed the differential between the average worker's wage and the manager's total income is probably wider in the USSR than it is in the U.S. This fact, of course, is not advertised and much of what the successful manager receives are the fringe benefits -- an apartment, a country house, the use of an automobile, travel and expense accounts, and the like.

Until quite recently, the major criterion for the compensation of business managers in the USSR had been the fulfillment of the physical output goals assigned to the plant by central authorities. This has meant that costs of production and quality have been relatively unimportant to Soviet managers for too long. They have operated under conditions of a perpetual seller's market, with the emphasis on physical volume of production, and this has created one of the major difficulties in their business organization.

Furthermore, in the Soviet Union there is no price competition, since the government is the sole purchaser for the vast majority of the Soviet production.

Take shoes, for example: Soviet footwear simply has not been as good as shoes produced in any other country. In October 1959 a letter to a Moscow newspaper, signed simply "Soviet Citizen," said that the writer was more interested in new shoes than he was in Sputniks or TU-114 airliners. He said that, as far as transportation was concerned, he was perfectly happy to ride the streetcar. However, he pointed out that his only pair of shoes was four years old and that they wouldn't have lasted that long had they not been a Western brand. The Moscow newspaper printed this letter, calling the writer a slug and an earthworm who was incapable of understanding the higher reaches of the communist way of life.

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This quality problem, as a matter of fact, has created one of the difficulties the Soviets have been running into in connection with some of their foreign aid programs. The goods delivered under these programs, other than military equipment, have not been up to standard in many cases.

The ablest managers and skilled workmen are largely reserved for heavy industry, particularly their defense programs, so the conditions I have described do not generally apply there. Consumer goods and light industry have both suffered from these circumstances.

But the point here is that the criteria by which Soviet managers have been evaluated and rewarded have been much simpler than ours. Thus, in contrast with an American businessman who has to balance costs, quality, profit, return on investment, production, company image, labor relations, market share, and a host of other considerations, the Russian manager's objectives are clear and well-marked. This inevitably means that they are easier to reach and their incentive power is great.

I wish now to turn briefly to the political environment in which the Soviet manager finds himself.

In the final analysis, there is only one industrial corporation in the USSR -- the Soviet State. This monolith, through a hierarchy of administrative organs, is an industrial giant whose employees number one-fifth more than the total number of workers in all manufacturing plants in the United States.

The chairman and members of the board of directors are the chairmen and various deputy chairmen of the Council of Ministers. In effect, the stockholders of the corporation are members of the Communist Party of the USSR.

It is no mere coincidence that Mr. Khrushchev is both chairman of the board and majority stockholder, in his dual role as Chairman of the Council of Ministers and First Secretary of the Communist Party. Furthermore, at the highest levels, a duality of individual roles in party-state positions is the

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rule rather than the exception. This means that, pursuing higher income and prestige, the Russian plant director, like the American manager, will strive to move from a small plant to a larger one, from a low-priority industry to one of higher priority. Alternatively, the plant director, being a member of the Communist Party, could seek advancement in industry through Party channels. He might, for example, be appointed to the strategic position of secretary in one of the regional Party committees.

In spite of recent gains in living standards, the ordinary Soviet citizen still finds himself essentially the residual claimant on output allowed him by these Party leaders-managers. The highly advertised "Communist Man" -- one who gives according to his abilities and receives according to his needs -- has yet to appear on the Soviet scene. Until he does, it is the principle of material gain that supplies the primary motivating force for the Soviet managerial class.

Salary scales are fixed by the USSR's State Committee on Labor and Wages in consultation with ~~believe it or not~~ the All-Union Central Council of Trade Unions. They are established, first of all, on the basis of importance to the State of a particular industry. Consequently, the major financial rewards lie in managing heavy industry and military facilities, not consumer goods plants. Thus, salaries are much higher in coal, metallurgy, and machine-building industries than in food and textile plants.

In addition to many "carrots," the Russian system of incentives for its managers also includes a number of "sticks." If a manager fails to perform as expected, not only does he lose his home, but he can also be fired, demoted, or reassigned to a job in a less important plant. If failures involve violations of the law, and they are quite likely to, he can be fined or imprisoned. He can also be expelled from Party membership, which would mean the end of his career as a manager.

Khrushchev underlined such disciplinary measures at a major Party meeting this January. Responding to a question as to what to do with Soviet executives who concoct inflated figures and fake statistics, he said;

"Out of the Party with them. These people are not Communists, they are hangers-on and should be punished. ... If we don't restore order, the plans will be statistically filled but there won't be enough products. As is known, you cannot make pancakes out of statistics."

Although unsuccessful Soviet managers are not likely to be sent off to Siberian forced labor camps any more, penalties for failure under the Soviet system are still far more severe than they are under ours.

One interesting sidelight on the Soviet system is that plant managers do occasionally manipulate output and inventory data, even at the risk of stiff jail terms and the ruin of their careers. There is plenty of evidence on this practice printed in the Soviet press almost daily. Why is it that Soviet managers take such chances?

Basically, because the centrally determined plant production goals are set very high, and a director's best efforts to meet goals are often frustrated by the failure of suppliers to deliver necessary materials. He takes a chance with ^{the} hope of being able to "catch up" in the next accounting period.

As long as a production enterprise is functioning reasonably well, the great variety of political "watchdogs", ^{who} ^{physically} ~~are~~ ^{are} always stationed ~~right~~ in the factory, look the other way. If a director needs to "borrow" a few per cent of next month's expected output to meet this month's plan goal, they allow him legal elbow room. But borrowing must be made up. If a director continues to fall behind, compounding shortages, one or another of the enterprise's watchdogs will denounce him to higher authorities and receive credit for uncovering an unsavory scandal.

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Impelling as it was towards maximization of output in the USSR, still a major goal, this incentive system had some built-in dis-incentives. To earn bonuses, managerial actions were not always in the best interests of the State. So about two years ago the Central Committee of the Communist Party took up the whole question of efficiency in industry, and last July they decided upon a number of specific reforms, which are now being introduced. They include:

1. Bonus arrangements for plant managers are now tied to reducing production costs, and in some cases to quality of product. Bonuses previously paid solely for fulfilling physical production plans are being discontinued.
2. To stimulate research and development on new high-performance equipment, experimental costs on such machines, until they go into series production, are no longer paid by the enterprise doing the development work. All these expenses now come out of a special fund, administered from the center at Moscow. This should have the effect of reducing prices on new equipment, as well as stimulating its development and production.
3. Large bonuses are now available to reward plant personnel who are directly connected with what is called "creation and introduction" of new technology. The size of the bonuses is computed by a complicated measurement of cost reduction achieved through introduction of new technology. Savings are computed in the plant making the innovation, and allowance is made for savings elsewhere in other facilities where the innovation can be adopted.
4. Bonuses are now paid quarterly instead of monthly to reduce end-of-month pressures and borrowing from future production.
5. At least 20% of a plant's retained earnings, called the "enterprise fund," must now be spent for the introduction of new technology, modernization of equipment, etc.

These incentives to promote greater technological advances and managerial efficiencies, important as they are, are not the end of changes. We can expect that there will be other measures introduced next year and in years to come, as the Soviets strive for increased efficiency to promote a high rate of economic growth. While it is always hazardous to forecast, it appears that the Soviets are on the right track in the major overhaul of methods of managerial compensation.

The incentives in industry, which have worked reasonably well and which if corrected as contemplated will work even better, are not reflected in ~~the state of~~ agriculture. Agriculture has been the "ugly duckling" in the Soviet economic drive. There is an affinity between the farmer and his farm; the satisfaction of outright ownership has not been reflected at all in the Soviet system of collectivization and the Soviets have paid a price for it. A man will work contentedly on the production line and accept his pay as full compensation for his labor; a farmer who tills the soil which belongs to a State cooperative finds little incentive to increase or economize in production. So, the farm continues to be a headache for Mr. Khrushchev and the statistics indicate a breakdown in the incentive system. By way of evidence, the Soviet Union employs about seven times as many workers on the farms as we do in the U.S. and produces one-third less in terms of value than do we. We can conclude that Marx and Lenin have not helped much in the field of agriculture.

Turning briefly to the professions, the incentives differ very largely between different branches. Soviet medical and legal professions enjoy neither the social status nor the income advantages of their counterparts in the U.S. But as a lawyer, I regret to have to add that this is because these professions are considered "non-productive" pursuits in the Soviet Union. It is no coincidence that the Soviet leaders have offered a special incentive to women in the professions. Three-quarters of Soviet doctors and physicians are women,

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compared with just over 5% in this country. About one-third of the lawyers in the Soviet Union are women. In this country it is less than 5%.

I willingly grant that women have special skills and talents in these fields. But the fact remains that the extensive use of women in these professions, and in the more highly paid teaching profession, does free men for work in priority Soviet defense and heavy industries.

Some reforms in the so-called non-productive professions are in prospect. I understand that a new wage scale will give them somewhat more income during the coming year.

In spite of what might seem to be serious defects in the incentive system that prevails in Soviet economic life, these are perhaps less important to them and for us than their overriding incentive or goal to ~~produce~~ to advance the cause of Communism, both in the Soviet Union and throughout the world. The Soviet leaders seem to have acquired a keen sense of what is important for these purposes. They have long neglected the creature comforts of their citizens in order to pour their resources into the essential underpinnings of strong industrial and military power and they have induced their citizens to accept this decision. We should clearly recognize the extent of their success. Whatever the excesses of their propaganda, they can rightfully claim truly remarkable industrial and scientific accomplishments.

We do not accept their view that Communism is the wave of the future. However, this is ~~their~~ conviction; this is their incentive for action; this is the basis for their domestic and foreign policies; and this is the nature of the threat and the challenge which they present.

I wonder if we are as clear in our own minds about our incentives as they are about theirs? The free world does not have a monolithic unity. We do not gear our industrial machine to compete in a statistical race with the Communist world. We do not try to impose our political system on others. Each of us has

~~some sense of~~ conviction about the ideals of freedom, democratic institutions, and the dignity of the individual, which may vary somewhat from those of our neighbor.

At the same time, we seem dedicated too much to our creature comforts, too little to the advancement of the great principles. In November of 1959 Christian Herter, who was then Secretary of State, made an eloquent address to the Foreign Trade Council, pointing out the stakes, the incentives, and the challenge. He said:

"We have, of late, been too absorbed, I feel, in the mere enjoyment of a prosperous life behind our defense curtain of nuclear power. We must realize instead that the fateful competition with Communism has placed a first claim on the energy and interests of us all. That means subordinating our private interests to the paramount public interest. It also means using our economy less for the things which do not really matter, and more for the things which do -- for the uses which would train and inform our minds, promote the health of our society and keep our country free."

More recently, the President told the American Society of Newspaper Editors:

"The message of Cuba, Laos, of the rising din of Communist voices in Asia and Latin America -- these messages are all the same. The complacent, the self-indulgent, the soft societies are about to be swept away with the debris of history. Only the strong, only the industrious, only the determined, only the courageous, only the visionary who determine the real nature of our struggle can possibly survive."

The business manager knows perhaps better than anyone else the state of our economy, the proportion of our effort as divided between our national security and our own comforts, and it is for him -- as it is for all of us -- to reexamine what our true incentives should be in these critical days.

Let us make no mistake about Communist intentions and capabilities. They are not about to inherit the earth economically, but they are going to use the period of so-called coexistence to carry out their political, economic, and subversive plans and thus endeavor to expand their power and to advance their prestige in the world. Even if they do make more concessions to the consumers, the major thrust of their economic development remains directed toward specialized industrial, military, and national power goals. The major thrust of our economy is still directed to production of consumer goods and this adds little muscle to our national security.

Comparisons between gross national products or indices of industrial production are not the important consideration. Our concern must be with the uses to which industrial strength is put.

The true measure of our relative power positions in the final analysis depends on what we do to defend our national security and to advance the cause of freedom here and throughout the world.

* * * *

SUMMARY OF REMARKS
by
ALLEN W. DULLES
DIRECTOR OF CENTRAL INTELLIGENCE
at
Thirty-First Annual National Business Conference
HARVARD BUSINESS SCHOOL
Boston, Massachusetts
9 June 1961, 7:30 P.M. (EDT)

"INCENTIVES IN THE SOVIET UNION"

I was honored to receive your invitation to participate in the 1961 National Business Conference and to visit again the Harvard Business School. I can testify from personal knowledge to direct and specific benefits which we in government have received both from you in business and you in the academy.

The Agency which I represent has been improved by close association with the Harvard Business School. Members of your faculty have visited our Agency, and we see to it that our senior executives seize their opportunities to enroll as students in the school. You have added to our incentive to improve management in a type of work which defies the ordinary rules of organization.

Incentive, the dictionaries tell us, is that which incites to determination and action, that which moves the mind or stirs the passions.

Incentives spring from two main sources. They are either imparted from without or engendered from within the individual.

External forces give incentive. A great crisis stirs men to action. A war incites us to deeds of courage and exhibitions of fortitude. Leaders of men, in free societies, in Government or in private life can also gain dominion over men's minds and become the incentive force that leads to

action. Dictators can also do this on a massive scale.

And then there are the incentives which come from within us -- ambition, religious fervor, the urge to reach for fame or fortune, to create, or to build. It may be an edifice, a work of art, a piece of literature, an invention, a business enterprise, a career.

In an open, free society, in a government of the people, and for the people, it is from the individual that the major incentives spring.

In a closed society, the individual is forced to look primarily to the dictator, to the leader, or to the State. But even here individual initiative, though restricted and often canalized by Government, may play a role.

Not many years ago we saw the strange and sad phenomenon of a great country and a great people where a mad dictator, Hitler, took hold of the people's minds and molded a controlling group into blind obedience to the state. Individual incentive was lost in the image of the state. Their bible was Main Kampf because a written charter can help to serve as the instrument for inspiring and controlling incentive.

In the Soviet Union the major incentives are derived from the dictates of the state.

True, as contrasted with the old Stalin days, there has been some relaxation under Khrushchev. The framework is more ample. But it is still the state which is the major element in providing and controlling the people's incentives. Here, too, they have their doctrinal literature, starting with the works of Marx and Lenin and, until his degradation, the teachings of Stalin.

An eminent student of Soviet affairs, Philip E. Mosely, writing in the April issue of Foreign Affairs, puts it this way:

"The picture of a Soviet system that has chosen, or been driven -- to abandon its police controls and to leave the way open to all kinds of initiatives welling up from below is a most appealing one, but one that can hardly stand the light of Soviet day."

But the Soviets are showing some degree of pragmatism and flexibility. Take the case of Lysenko, the notorious geneticist, whose theories have long been ridiculed by Western scientists and even by some of his Soviet colleagues. Khrushchev had this to say of him:

"Lysenko is a narrow, authoritarian, sectarian individual who wishes to impose his scientific doctrine on everybody by sending all those who don't agree with him to Siberia. He's an impossible person. However, I prefer a bad character who can grow wheat to a good character who can't."

Khrushchev has recognized that politics can not dictate the findings of the scientist. But while the scientist may be free to expound the laws of science, he is not free in charting the course of his conduct. There must be a conformity with the needs of the state.

In order to mold the Soviet people and to supply them the incentives to contribute to the growth of the Soviet Union, there are a series of incentive-creating principles which the Soviet leaders, and Khrushchev in particular, teach.

The first, and possibly the most important, is the doctrine they preach, of the supremacy of the communist way of life. Communism they

portray as the wave of the future. We will bury you, Khrushchev says to the rest of us, but not physically -- merely by evidencing the superiority of our system, the decadence of yours. As capitalism took over from feudalism, so communism will take over from capitalism, he preaches.

Second, Khrushchev preaches that communist society has found the keys to industrial and scientific progress; that it is moving ahead at a faster rate than its great industrial rival, the United States; and that in the course of a decade or so it will surpass us in the actual value of its industrial production. Meanwhile, the Soviets claim leadership in space, in ballistic missiles, and in certain other fields of industrial endeavor.

And finally, to maintain communist growth, Khrushchev enjoins each and every Soviet citizen to play his part in the manner and form dictated by the state. He must devote to the state the product of his mind; the fruits of his toil. He must help to overfulfill the economic plan goals.

When Khrushchev visited Los Angeles in September 1959, he engaged in a brisk debate with one of his hosts at a luncheon. The issue was as to who had come from the humblest beginnings to the highest place in life and society. In the course of it, Khrushchev called on the Chairman of the Dnepropetrovsk Economic Council to rise and take a bow. He pointed out that this official administered huge metallurgical plants and chemical factories. A third of the ore mined in the Soviet Union comes from his region. No one in the United States controlled so much wealth, he said.

Khrushchev went on to say that this official possesses nothing except the pants he wears. All the rest belongs to the people. However, Soviet officials do possess great power as well as pants, and power is a tremendous incentive to the ambitious Soviet citizen.

There are other built-in incentives to the Communist scheme of things.

The Soviets were the first to develop the idea of the five-year plan with an indication of how much should be produced each year. This makes each industrial worker a kind of participant in the race to see that each year's goal and the total is over-fulfilled.

In effect, every Soviet worker is taught to feel that he is an integral part of this great industrial marathon between the U.S. and the Soviet Union. Travelers to the Soviet Union report that on cowbarns in various parts of the USSR the slogan "Beat America" is inscribed.

In a free society, we do not attempt to gear our industrial production to that of any other country. It is largely a response to the demands of the market place; what the people may desire to acquire to advance their standards of living.

In addition to what I have been describing as the overall popular incentive to help realize national goals, there are managerial incentives applicable to industry. The nature of these incentives has been a matter of unprecedented concern in the USSR over the past two years.

It is quite clear that Soviet political leadership has succeeded in devising incentives which bring capable managers to positions of key responsibility even though, in the Soviet Union, the politicians do not trust the business managers. To help control them they have established elaborate controls and checks on enterprise heads which are under the supervision of local Communist party types. These include: the setting of detailed production targets; the allocation of raw and semi-processed materials; the control over manpower; the allocation of investment funds; the control over prices; and the monitoring of performance.

The Party sees to it also that the managerial class is very well paid by Soviet standards. Indeed the differential between the average worker's wage and the manager's total income is probably wider in the USSR than in the U.S. This is not, of course, advertised and much of what the successful manager receives are the fringe benefits in the form of an apartment, a country house, the use of an automobile, travel and expense accounts and the like.

Until quite recently, the major criterion for the compensation of business managers in the USSR had been the fulfillment of physical output goals, assigned to the plant by central authorities. This has meant, and it has been one of the difficulties of their business organization, that costs of production have, for too long, been relatively unimportant to Soviet managers. They have operated under conditions of a perpetual seller's market with emphasis on physical volume of production.

In the Soviet Union there is no question of price competition since the Soviet government is the sole purchaser for the vast majority of the Soviet production. Quality has, until recently, been too much neglected.

For example, the output of shoes by Soviet factories has not been in a quality competition with shoes produced by any other factory. Speaking of shoes, in October 1959 a letter to a Moscow newspaper signed "Soviet citizen" said that the writer was more interested in new shoes than he was in Sputniks or TU-114 airliners. He said that as far as transportation was concerned, he was perfectly happy to ride the streetcar. However, he pointed out that his only pair of shoes was four years old and that they wouldn't have lasted that long except they were a Western brand. The Moscow newspaper printed this letter calling the writer a slug and an earthworm, who

was incapable of understanding the higher flights of the Communist way of life.

As a matter of fact, one of the difficulties the Soviets have been running into in connection with some of their foreign aid programs is the fact that the goods delivered under these programs -- I am not speaking now of military equipment -- have in many cases not been up to standard.

What I have said here applies chiefly to the consumer goods area of their production and light industry. Their ablest managers and skilled workmen are largely reserved for their heavy industry, particularly in their defense programs.

I wish now to turn briefly to the political environment in which the Soviet manager finds himself.

In the final analysis, there is only one industrial corporation in the USSR -- the Soviet State. This monolith, through the hierarchy of administrative organs, is an industrial giant whose employees number one-fifth more than the total number of workers in all manufacturing plants in the United States.

The chairman and members of the board of directors are the chairmen and various deputy chairmen of the Council of Ministers. In effect, the stockholders of the corporation are members of the Communist Party of the USSR.

It is no mere coincidence that Mr. Khrushchev is both chairman of the board and majority stockholder, in his dual role as Chairman of the Council of Ministers and First Secretary of the Communist Party. Furthermore, at the highest levels, a duality of individual roles in party-state positions is the rule rather than the exception.

In spite of recent gains in living standards, the ordinary Soviet citizen still finds himself essentially the residual claimant on output allowed him by the Party leaders.

The highly advertised "Communist Man" -- one who gives according to his abilities and receives according to his needs -- has yet to appear on the Soviet scene. Until he does, it is the principle of material gain that is applied as the primary motivating force for the Soviet managerial class. Salary scales are fixed by the USSR's State Committee on Labor and Wages in consultation with -- believe it or not -- the All-Union Central Council of Trade Unions.

Salaries are set first of all on the basis of importance of a particular industry to State. This means the major financial rewards are in managing heavy industry and military facilities, not consumer goods plants. Thus, salaries are much higher in coal, metallurgy and machinebuilding industries than in food and textile plants.

Pursuing higher income and prestige, the Russian plant director, like the American manager, will strive to move from a small plant to a larger one, from a low-priority industry to one of higher priority.

Or the plant director, being a member of the Communist Party, could seek advancement in industry through Party channel advancement. He might, for example, be appointed to the strategic position of Secretary in one of the regional Party Committees.

Besides earning his salary, bonuses, expense account, car and preferential housing to which I have referred -- the Soviet manager has other concerns which affect his advancement.

The Soviet manager has much more responsibility for his workers than does his American counterpart. He controls schools, housing, rest homes, and part of the food supply of all the workers in his plant. He has, justifiably, a strong sense of paternal power.

In addition to many "carrots," the Russian system of incentives for its managers also includes a number of "sticks." If a manager fails to perform as expected, not only does he lose his home, but also he can be fired, demoted, or reassigned to a job in a less important plant.

If failures involve violations of the law, and they are quite likely to, he can be fined or imprisoned. He can also be expelled from Party membership, which would mean the end of his career as a manager.

Khrushchev made this plain at a major party meeting this January. Responding to a question on what to do with Soviet executives who concoct inflated figures and fake statistics, he said,

"Out of the Party with them. These people are not Communists, they are hangers-on and should be punished. ... If we don't restore order, the plans will be statistically filled but there won't be enough products. As is known, you cannot make pancakes out of statistics."

Although an unsuccessful Soviet manager is not likely to be sent off to Siberian forced labor camp these days, penalties for failure under the Soviet system are more severe than they are under ours.

Yet plant managers do occasionally manipulate output and inventory data even at the risk of stiff jail terms and the ruin of their careers. There is plenty of evidence on this practice printed in the Soviet press almost daily. Why do Soviet managers take such chances?

Basic reasons are: (1) centrally determined plant production goals are set very high, and: (2) a director's best efforts to meet goals are often frustrated by the failure of suppliers to deliver necessary materials. He takes a chance with a hope of being able to "catch up" in the next accounting period.

As long as a production enterprise is functioning reasonably well, the great variety of political "watchdogs," which are always stationed right in the factory, look the other way. If a director needs to "borrow" a few per cent of next month's expected output to meet this month's plan goal, they allow him legal elbow room. But borrowing must be made up. If a director continues to fall behind, compounding shortages, one or another of the enterprise watchdogs will denounce him to higher authorities and receive credit for uncovering unsavory scandal.

The key question for a Soviet manager is, how much did you turn out last month, not how much profit did you show?

Impelling as it was towards maximization of output in the USSR, still a major goal, this incentive system had some built-in dis-incentives. To earn bonuses, managerial actions taken were not always in the best interests of the State.

About two years ago the Central Committee of the Communist Party took up the whole question of efficiency in industry, and last July they decided upon a number of specific reforms which are now being introduced. They include:

1. Bonus arrangements for plant managers are now tied to reducing production costs, and in some cases to quality of product. Bonuses previously paid solely for fulfilling physical

production plans are being discontinued.

2. To stimulate research and development on new high performance equipment, all experimental costs on such machines, up to the stage where they go into series production, are no longer paid for by the enterprise doing the development work. All these costs are now paid for out of a special fund, administered from the center at Moscow. This should have the effect of reducing prices on new equipment, as well as stimulating its development and production.

3. Large bonuses are now available to reward plant personnel who are directly connected with what is called "creation and introduction" of new technology. The size of the bonuses is computed by a complicated measurement of cost reduction achieved through introduction of new technology. Savings are computed not only in the plant making the innovation, but also allowance is made for savings elsewhere in other facilities where the innovation can be adopted.

4. Bonuses are now paid quarterly instead of monthly to reduce end-of-month pressures and borrowing from future production.

5. At least 20 per cent of what is called "enterprise fund," which essentially is a plant's retained earnings, must now be spent for the introduction of new technology, modernization of equipment, etc.

These incentives to promote greater technological advances and managerial efficiencies, important as they are, are not the end of changes. We can expect that there will be other measures introduced next

year and in years to come, as the Soviets strive for increased efficiency to promote a high rate of economic growth.

While it is always hazardous to forecast, it appears that the Soviets are on the right track in the major overhaul of methods of managerial compensation.

The incentives in industry, which have worked reasonably well and which if corrected as contemplated will work even better, are not reflected in the field of agriculture. Agriculture has been the "ugly duckling" in the Soviet economic drive. There is an affinity between the farmer and his farm; the satisfaction of outright ownership which has not been reflected at all in the Soviet system of collectivization. A man will contentedly work on the production line and accept his pay as full compensation for his work. A farmer who tills the soil which belongs to a State cooperative finds little incentive to increase or economize in production. In any event, the farm continues to be a headache for Mr. Khrushchev and the statistics indicate a breakdown in the incentive system.

For example, the Soviet Union employs about seven times as many workers on the farms as we do in the U.S. and produces one-third less in terms of value than do we.

In any event, we must conclude that Marx was not much of a farmer and the principles of Marx and Lenin have not helped much in the field of agriculture.

Turning briefly to the professions, the incentives differ very largely between different branches. Soviet medical and legal professions enjoy neither the social status nor the income advantages of their counterparts in the U.S. But as a lawyer, I regret to have to add that this is because

in the Soviet Union these professions are considered non-productive pursuits in the Soviet terminology.

The Soviet leaders have offered a special incentive to women in the professions. Three-quarters of Soviet doctors and physicians are women. This compares with just over five percent in this country.

About one-third of the lawyers in the Soviet Union are women. In this country it is less than five percent.

I willingly grant that women have special skills and talents in these fields. But the fact remains that the extensive use of women in these professions and in the more highly paid teaching profession, does free men for work in priority Soviet defense and heavy industries.

Some reforms in the so-called non-productive professions are in prospect. I understand that a new wage scale will give them some more income during the coming year.

In spite of what might seem to be serious defects in the incentive system that prevails in Soviet economic life, these are perhaps less important to them and for us than their overriding incentive or goal to produce to advance the cause of communism both in the Soviet Union and throughout the world.

The Soviet leaders seem to have acquired a keen sense of what is important for these purposes. They have long neglected the creature comforts of their citizens in order to pour their resources into the essential underpinnings of strong industrial and military power and they have induced their citizens to accept this.

The extent of their success should be clearly recognized by us. Whatever the excesses of their propaganda, they can rightfully claim truly

remarkable industrial and scientific accomplishments.

We do not accept their view that communism is the wave of the future. However, this is their conviction; this is their incentive for action; this is the basis for their domestic and foreign policies; and this is the nature of the threat and the challenge which they present.

I wonder if we are as clear in our own minds about our incentives as they are about theirs? The free world does not have a monolithic unity. We do not gear our industrial machine to compete in a statistical race with the communist world. We do not try to impose our political system on others. Each of us has some sense of conviction about the ideals of freedom, democratic institutions, and the dignity of the individual.

At the same time, we seem dedicated too much to our creature comforts, too little to the advancement of the great principles. In November of 1959 your former Governor Christian Herter, who was then Secretary of State, made an eloquent address to the Foreign Trade Council, pointing out the stakes, the incentives, and the challenge. He said:

"We have, of late, been too absorbed, I feel, in the mere enjoyment of a prosperous life behind our defense curtain of nuclear power. We must realize instead that the fateful competition with communism has placed a first claim on the energy and interests of us all. That means subordinating our private interests to the paramount public interest. It also means using our economy less for the things which do not really matter, and more for the things which do -- for the uses which would train and inform our minds, promote the health of our society and keep our country free."

More recently, the President told the American Society of Newspaper Editors:

"The message of Cuba, Laos, of the rising din of communist voices in Asia and Latin America -- these messages are all the same. The complacent, the self-indulgent, the soft societies are about to be swept away with the debris of history. Only the strong, only the industrious, only the determined, only the courageous, only the visionary who determine the real nature of our struggle can possibly survive."

You here tonight know perhaps better than anyone else the state of our economy, the proportion of our effort as divided between our national security and our own comforts, and it is for you -- as it is for all of us -- to reexamine what our true incentives should be in these critical days.

Let us make no mistake about communist intentions and capabilities. They are not about to inherit the earth economically, but they are going to use the period of so-called coexistence to carry out their political, economic and subversive plans and thus endeavor to expand their power and also to advance their prestige in the world. Even if they do make more concessions to the consumers, the major thrust of their economic development remains directed toward specialized industrial, military, and national power goals. The major thrust of our economy is still directed to production of consumer goods and this adds little strength to our national security.

Comparisons between gross national products or indices of industrial production are not the important consideration. Our concern must be with the uses to which industrial strength is put.

The true measure of our relative power positions in the final analysis depends on what we do to defend our national security and to advance the cause of freedom here and throughout the world.

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**CENTRAL INTELLIGENCE AGENCY
OFFICIAL ROUTING SLIP**

TO	NAME AND ADDRESS	INITIALS	DATE
1	Col. Grogan	<i>AG</i>	JUL 18 REC'D
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ACTION	DIRECT REPLY	PREPARE REPLY
APPROVAL	DISPATCH	RECOMMENDATION
COMMENT	FILE	RETURN
CONCURRENCE	INFORMATION	SIGNATURE

Remarks:

For your information and necessary action.

Walt:

I think you should handle this.


 Stanley G. Grogan
 Assistant to the Director
 18 July 1961 STAT

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ADDRESS AND PHONE NO.	DATE
Asst. to the DCI	7/18/61